11/7/83
Financial Markets
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Irving Trust

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Financial innovation continues as a major theme in the U.S. financial markets. Innovations that affect depositors by lifting interest rate ceilings, changing reserve requirements, and reducing minimum deposit requirements make more difficult the job of monetary management. All of these regulations have been in a state of flux this year, even as the job of monetary management has gotten to be more important. The critical stage of the business cycle and the pressing concerns over the international debt problem have reemphasized the role of monetary policy in an environment of colossal government budget deficits.

It is not new to say that financial deregulation affects aspects of monetary policy, but let's look closely at the latest changes. Interest rate ceilings have been removed from time deposits of maturity greater than 31 days and less than 2½ years, giving banks greater flexibility in serving their clients in these intermediate maturity instruments. These accounts likely will draw funds from the popular MMDA accounts and from the money market mutual funds. Such deposit shifts have no obvious impact on the monetary aggregates, as all these accounts are contained in M2.

There remains a possibility, however, that some new deposits may be taken from sources outside M2 and M3. For example, some deposits might shift in from Banker's Acceptances (BAs) or U.S. Treasury Bills. Some of this type of shift occurs indirectly when balances flow out of money market mutual funds (MMMF), which then sell assets to cover the withdrawal. As MMMFs hold U.S. Treasuries, BAs', and other instruments, when balances shift out of MMMFs, there is a reduced demand for the instruments that the MMMFs hold, at least initially.

Investments that migrate directly out of BAs or Treasuries or indirectly out of MMMFs to banks' accounts do not disappear. They are redeployed by the banks. Thus the ownership of the ultimate asset changes. Through this process, known as reintermediation, banks come to hold more of the public's deposits. The banks thereby come to hold more assets which are supported by these deposits. When loan demand is slack, this means that banks themselves come to hold more U.S. government securities: very safe, very liquid, but relatively low in yield.

As banks hold more of the public's deposits, the broad money supply--M2 and M3--tends to be inflated. Yet, as the previous discussion makes clear, there is nothing particularly troublesome or inflationary about this process. This reintermediation is due to changes in the rules governing what banks can do. Indeed the narrow aggregate, M1, might even be increased temporarily, if it is used as a transactions medium for such financial transfers. Thus the bottom line is that the Fed must not only look at money growth, but must also guess at its root causes. This is why judgment is paramount in the current making of monetary policy.

Robert A. Brusca

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Market Yields

	10/28/83 (Noon)	Week Ago	Year Ago
Prime Lending Rate at Irving Trust Company	11.00%	11.00%	12.00%
Effective since	8/8/83		
Discount Rate at Federal Reserve Bank	8.50	8.50	9.50
Federal Funds	9.31	9.31	9.25
Repurchase Agreements	9.20	9.25	8.88
U.S. Treasury Issues			
Bills			
3 months	8.92	8.82	8.12
6 months	9.34	9.23	8.84
1 year	9.70	9.64	9.23
Coupons			
2 years	10.59	10.50	9.86
4 years	11.15	10.98	10.49
7 years	11.54	11.39	10.71
10 years	11.65	11.45	11.18
Long Bond	11.70	11.51	11.06
Negotiable Certificates of Deposit-Secondary Market			
1 month	9.15	9.10	8.90
3 months	9.25	9.15	9.05
6 months	9.35	9.30	9.35
1 year	9.80	9.80	9.70
Banker's Acceptances			
1 month	9.17	9.10	8.90
3 months	9.25	9.21	9.10
6 months	9.43	9.31	9.35
Eurodollar Deposits			
1 month	9.56	9.50	9.75
2 months	9.69	9.56	10.00
3 months	9.69	9.63	10.13
Commercial Paper - Prime Names			
Directly placed by:			
Finance Companies			
1 week	9.24	9.14	9.02
1 month	9.25	9.19	8.94
3 months	9.21	9.21	8.81
Bank Holding Companies			
1 month	8.94	8.81	8.04
Dealer Placed:			
3 months	9.35	9.31	8.54
New AA Corporate Utility Bond	12.85	12.50	12.75
Tax Exempt			
6 month Project Notes	5.30	5.25	4.20
1 year AAA Bond	5.50	5.50	6.00
5 year AAA Bond	6.60	7.00	7.40
20 year AAA Bond	9.00	9.60	9.40

This information represents prevailing market yields.
It should not be construed as an offering.
All yields are on the offered side of the market.

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